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A RESPONSE TO PROFESSOR BAIRD'S ESSAY ON UNWRITTEN LAW: WRITING SOME UNWRITTEN LAW

Richard Levin[*]

In his essay, "*The Fraudulent Conveyance Origins of Chapter 11: An Essay on the Unwritten Law of Corporate Reorganization*,"[1] Professor Baird sets out his view of the core of the unwritten law the bankruptcy judge must enforce:

> When the question is one of policing the behavior of creditors during the bankruptcy process, the judge is asking whether the overall negotiations were conducted in a fashion that could be trusted to maximize the value of the assets within the bankruptcy estate . . . . Protecting the bargaining environment rather than ensuring proper division of the assets is the task at hand. Ensuring that distributional rules are followed is necessary to do this and hence a necessary part of ensuring that the players follow the rules of the game, but it is hardly the only part.[2]

Moreover, "Distributional irregularities are usually a symptom, not the disease. The prime directive is ensuring the integrity of the process."[3] By that, he appears to mean assuring "everyone had a chance to participate in the bargaining process on fair terms."[4]

Process has always had an important role in American jurisprudence and especially in reorganization-land. Both the Supreme Court and the Second Circuit have recently recognized the right to negotiate, almost as a separate due process right.[5] But substance in this context is not just an indicator of process. The statutory distributional rule—the actual *written* rules—matter in and of themselves. Distributional outcomes may indeed show whether the process, as Professor Baird defines it, was proper. But distributions that do not strictly follow distributional rules can also be the result of an entirely proper process.

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[1] Douglas Baird, *The Fraudulent Conveyance Origins of Chapter 11: An Essay on the Unwritten Law of Corporate Reorganization*, 36 EMORY BANKR. DEV. J. 699 (2020) [hereinafter "Essay"].

[2] *Id.* at 709. I quibble with the "maximizing the value" goal here, because distributional negotiations only sometimes affect the size of the pie rather than the division of the pie, and the rest of the Essay gives little weight to this goal.

[3] *Id.* at 711.

[4] *Id.* at 704.

[5] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 983 (2017) (reversing settlement approval because the objectors "lost a chance to obtain a settlement"); Elliott v. Gen. Motors LLC, 829 F.3d 135, 166 (2d Cir. 2016) (release not binding because lack of notice prevented plaintiffs from participating in negotiations in which "there was a reasonable possibility that [they] could have negotiated some relief . . . .").

Both must be proper, not just the process. The trick is distinguishing when both are proper and when one or both are not.

I suspect that by "unwritten rules," Professor Baird means the ways in which courts decide this question. But I am not sure the rules are wholly unwritten. As Professor Baird acknowledges, there is a substantial body of case law addressing this question.[6] I do not consider case law "unwritten."[7] By contrast, I would characterize as "unwritten" Professor Baird's "rule" that in the reorganization arena, players stab others only in the chest, not in the back.[8] In any event, I believe the rules are clear enough from the case law and from the simple extension that in a bold (and perhaps foolish) step, it might be possible to synthesize those rules.

I start with the premise that a business buyer generally does not pay more than what it believes the target asset is worth, and a business generally does not make a true gift in connection with a transaction in which it is participating. It expects value in return.[9] The value might be tangible—the acquisition of an asset—or it might be to obtain the services or goodwill of someone important to the transaction. A bankruptcy judge supervising a transaction in a reorganization case must be aware of this business principle in policing the negotiations toward a conclusion to the case and considering the deal the parties ultimately bring forward for approval.

How does this principle apply to a buyer[10] in a reorganization transaction? A buyer has two principal categories of costs in acquiring a business. It pays for the value of the business itself, and it pays transaction costs. The transaction costs will be capitalized along with the purchase price. From the buyer's longer-term perspective, those costs are fungible. Ordinarily, transaction costs are small relative to business value, but they can mount in a contentious chapter 11 case. And cantankerous creditors can cause those costs to grow substantially.[11] A

[6] *See generally* Baird, *Essay*, *supra* note 1.

[7] George Treister, in particular encouraged those of us writing the Bankruptcy Code to draft in broad strokes and not get too detailed, leaving the application of the broad principles to the courts to develop in the context of particular cases. We followed his advice only in part. The resulting case law is as binding as the Code itself, sometimes more so. Of course, things have gotten much worse since then. *See, e.g.*, 11 U.S.C. §§ 524(g) (governing reaffirmation agreements); 707(b) (governing what constitutes an abuse of chapter 7 for a consumer debtor).

[8] Baird, *Essay*, *supra* note 1, at 716.

[9] Is this an "unwritten law?"

[10] "Buyer" might include not just a buyer at a § 363 sale but also the resulting owner after an internal reorganization, whether that is the creditors who acquire the equity of the reorganized debtor or a plan proponent who funds the reorganization and acquires ownership.

[11] This is nothing new to the Code or even the Act that preceded it. Adrian H. Joline, *Railway*

buyer would normally expect to budget transaction costs as part of planning the transaction, and anything that would reduce transaction costs would likely allow the buyer to bid more for the asset itself.

That principle can be illustrated with the hypothetical Professor Baird's Essay poses, which is loosely based on the facts in *In re ICL Holding Co., Inc.*[12] There, the buyer funded a settlement for the administrative priority professional fees and general unsecured creditors, leaving nothing for the government's administrative priority tax claim. The court agreed with the bankruptcy court's characterization that the funds "belong[ed] to the purchaser[] [and] not to the debtors' estate"[13] and therefore were not subject to the Bankruptcy Code's (Code) distributional priorities.

Let us simplify the hypothetical. The estate's sole assets are a widget and $100 in cash, and it owes creditors $200, including $10 to the widget repair company. A buyer is willing to pay $150 for both the widget and the cash. It makes no difference whether the buyer is an unrelated purchaser or a secured creditor who is credit-bidding its claims. One might surmise the buyer values the widget at $50. But the buyer says it is going to add $10 of its own cash to establish a trust fund to pay the case professionals. Does anyone doubt the buyer values the widget at $60? But no, says the bankruptcy court. That extra $10 is not property of the estate or proceeds of property of the estate that is subject to the Code's distribution scheme; it is the buyer's property, which it can do with what it wants. Nonsense.

Suppose the buyer needs the repair company to be available to maintain the widget in the future, and the repair company will refuse unless its claim is paid, so the buyer agrees to pay the repair company's $10 claim in addition to the $150 it is paying for the cash and widget. It is still clear the buyer values the widget with the availability of future repair at $60. We do not know how the buyer values the widget without repair availability, but probably not at $60 or even $50, since the repair bill is unrelated to the widget's inherent value.

How should we view this situation? Here, the estate is better off with the repair company paid. So, the estate itself might even pay the repair company before the auction.[14] This is not a process question, only a distributional question

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Reorganizations, 4 THE BRIEF 1, 20 (1902) (referencing "guerillas who hang about the outskirts of reorganizations and endeavor to levy tribute as a condition of abating the nuisance of their presence.").

[12] *In re* ICL Holding Co., Inc. 802 F.3d 547 (3d Cir. 2015).

[13] *Id.* at 556 (alterations in original).

[14] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 986 (2017) (payment of a prepetition claim might enhance the overall value of the estate for the remaining creditors); *In re* Kmart Corp., 359 F. 3d 866 (7th

with a goal, as Professor Baird describes, to determine what maximizes the value of the estate. The same be can be said of payments to customers, such as honoring frequent flyer miles, customer deposits, or warranty claims, some of which might be entitled to priority in any event.[15] These creditors have no control over or even a role in the chapter 11 process or the negotiations and voting over plan distributions that Professor Baird would protect. So, payment cannot be seen as corrupting the process or the distributions. Outside of distributional negotiations, we should be comfortable leaving the decision whether to pay them or honor their claims without regard to the statutory priorities to the trustee's or debtor in possession's business judgment of whether payment will enhance the estate's overall value, subject to the right of parties in interest to object and to the court's approval. But that is a decision for the estate, whose property is at stake, not for the buyer, whose money it isn't once the buyer decides to devote it to acquiring the asset.[16]

At the other extreme, a buyer's payment to one or more parties in interest who have a role in or influence over the conduct of the chapter 11 case and plan or distribution negotiations is inherently suspect. This might include a no-look post-sale consulting contract for the debtor's CEO, or a tip to equity holders, who might control the debtor, when junior claims are not being paid in full.

Payments to people who are not involved in the bargaining are prima facie proper. Payments to people who are involved in the process are different. Control rights have value. *203 N. LaSalle*[17] strongly suggests they do not belong to any particular class of creditors or equity holders. Even though § 1121 gives the debtor, controlled by the equity holders, plan exclusivity, the Supreme Court concluded that the equity could not arrogate the value of that control right to itself without consideration of creditors with higher priority, and that seems consistent with the railroad reorganization cases Professor Baird describes. Moreover, if a buyer pays a control premium in a purchase of the estate's business, the premium is unquestionably property of the estate that must be

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Cir. 2004).

[15] 11 U.S.C. § 507(a)(7) (2019) (consumer deposit priority). Professor Baird equivocates on whether customer goodwill is property of the estate. I would view customer goodwill as an asset on which the estate has a call option that is not necessarily exclusive but worth more to the debtor's estate than to a competitor.

[16] I would make an exception for the buyer's payment of any amounts to any of the debtor's creditors the buyer chooses after, not in connection with, the transaction. As noted above, a rational business doesn't make gifts, so we can assume any such payment is intended to enhance the value of the business in the buyer's hands. And I would make an exception to that exception if it turns out the buyer had agreed to pay off some creditors to induce them to refuse to deal with other buyers—not likely a frequent occurrence in this context, and probably illegal under other laws to boot.

[17] Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

distributed in accordance with the Code's priorities. Thus, non-Code distributions to parties who might have legal or actual control over the estate, or the debtor, are prima facie improper and should be subject to higher scrutiny, just as courts impose higher scrutiny on interested party transactions under the business judgment rule.[18]

Somewhere in between lies the negotiations over plan distributions among classes of claims and equity interests. As originally designed, the Code contemplated senior creditors accepting less than their theoretical full entitlement to avert the delay, expense, and uncertainty associated with nonconsensual confirmation and judicial valuation. Tough negotiations over those matters should not raise alarms about process, side-deals, or bribes, as long as the Code's express rules are honored, including equal treatment within each class[19] and no nonconsensual class-skipping.[20]

Averting delay, expense, and uncertainty through a consensual plan is an important goal of the Code's reorganization system. The Code contemplated the negotiations would involve a comparison of the proposed deal with the outcome under a strict priority plan under § 1129(b). So the negotiators will advance their competing views about the likely outcome and will threaten litigation, increasing delay, expense, and uncertainty. Suppose a buyer or senior class believes that without concessions, litigation would be likely, but the risk of loss would be low. Still, there is delay, expense, and uncertainty. The senior class's agreement to allow value to flow to junior classes can be seen as a reasonable trade. The same analysis applies whether the plan is an internal reorganization, a credit bid[21] from the secured creditors, or the distribution of consideration from a buyer. The only constraint is § 1123(a)(4)'s equal treatment requirement.[22] But none of this has anything to do with maximizing the value of the estate, as the payments in the first example above might. We are only dividing the pie, not baking it.

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[18] *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A. 2d 1261, 1281 (Del. 1989) ("When faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts.").

[19] 11 U.S.C. § 1123(a)(4) (2019).

[20] 11 U.S.C. § 1129(b)(2)(B) (2019); DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 88, 95 (2d Cir. 2011); *In re* Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005).

[21] *See* 11 U.S.C. § 363(k) (2019); RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639 (2012) (credit bidding under 11 U.S.C. § 1129(b)(2)(A)).

[22] *See* Young v. Higbee Co., 324 U.S. 204, 213 (1945) ("The money [the objectors] received in excess of their own interest as stockholders was not paid for anything they owned. It came to them in settlement of litigation which if carried to a successful conclusion would have added to the value of other preferred stockholders of the common debtor.").

These examples allow formulating and writing down the law that Professor Baird characterizes as unwritten. The law would address payments that deviate in some fashion from the Code's priority scheme, including §§ 507(a) and 1129(b)(2), and assume full disclosure[23] and no suspicious activity. If the payment is designed to enhance the estate's value, which benefits all creditors, it should be permitted, even if it is not distributed pro rata to all members of the class.[24] If the payment resolves interclass disputes over entitlements, it should be permitted, as long as it is distributed pro rata to all members of the class and any intermediate classes accept the plan. However, if the payment is made from property of the estate, broadly and properly understood, even property that the estate might have difficulty realizing, and does not meet these tests, then it is improper and should be disallowed. Finally, payments in settlement of disputes to resolve legal or factual issues or reduce transaction costs (delay, expense, and uncertainty) should be treated as coming from property of the estate and should be permitted, subject to the same principles. Additional complexity can arise when evaluating forbearance fees, early consent fees, and subscription rights and associated fees, among other payments, against this rubric, but for now, they are beyond the scope of this short reply to Professor Baird.[25]

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[23] The Code and bankruptcy rules impose extensive disclosure requirements, as does the case law. *See* 11 U.S.C. § 1125 (2019) (court approval of disclosure statement containing "adequate information" before soliciting plan acceptances); Fed. R. Bankr. P. 1007 (debtor's schedules of assets and liabilities and statement of financial affairs), R. 2014 (disclosure of professionals' "connections" with the debtor, creditors, and other parties in interest), R. 2019 (creditor groups' disclosure of membership, holdings, and internal agreements). It is unclear what is "unwritten."

[24] Equal treatment for similarly situated creditors is an important bankruptcy principle. *See* 11 U.S.C. § 1123(a)(4); Begier v. IRS, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code.").

[25] The common law is the history of judges coming up with an answer on a new issue that arises, followed by other judges in later similar (but not identical) cases, to the point where we can induce a rule from what many judges have done in many cases. At that point, the rule gets formalized. A good example, as Professor Baird notes in the larger work from which the Essay is derived, is the Uniform Fraudulent Conveyance Act, which codified over four centuries of fraudulent transfer case law. UNIF. FRAUDULENT TRANSFER ACT (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 1918).
In that spirit, and constrained in my thinking as I am by my early training in drafting statutes, a rough statutory draft of these principles (that is, the written law) might read:

> A court should permit a payment from property of the estate (broadly defined) that deviates in some fashion from the Code's priority scheme, including sections 507(a) and 1129(b)(2), only if—
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> (1) the payor discloses fully the facts and circumstances concerning the payment;
> (2) the court determines that the payment does not involve any suspicious activity;[*] and
> (3)(A) the payment is designed to enhance the estate's value;
> (B)(i) the payment resolves interclass disputes over entitlements;
> (ii) the payment is distributed pro rata to all members of the class; and
> (iii) any intermediate classes accept; or
> (C) the payment settles a bona fide dispute over legal or factual issues in the case.

These written rules can explain both *Jevic* and *ICL*, or at least what should have been the result in *ICL*. In *Jevic*, the senior creditor proposed to pay money to the priority administrative, priority tax, and nonpriority unsecured creditors, skipping over priority wage claims, in settlement of a claim the estate had against senior creditors.[26] The estate's claim was clearly property of the estate. The senior creditors were willing to do the deal not only to resolve their possible liability to the estate on the estate's claim but also, quite candidly, to prevent the wage priority claimants from receiving the money, which they feared would use any distribution to fund litigation against the senior creditors on their own claims.[27] The settlement used proceeds of property of the estate—the senior creditors' payment for a release from the estate's claims. Its distribution to certain creditors, even pro rata, did nothing to enhance the estate's value and did not resolve interclass entitlement disputes. The proposed payment to the administrative, tax, and unsecured creditors without payment of the priority wage claims did not comply with the Code's priority scheme, and the intermediate class (priority wage claims) did not accept. It was a side deal, plain and simple, to get out of the case and provide some protection against litigation in which the estate had no interest. Therefore, it was properly disallowed.

In *ICL*, the secured lender credit bid its claim for all the estate's assets, including its cash, agreed to put funds into escrow to pay the estate's professional fees and, to settle an unsecured creditors' committee objection to the sale, to fund into escrow a small distribution to unsecured creditors.[28] The sale resulted in a large, administrative priority capital gain tax, which would not be paid from the escrow or the settlement fund.[29] Because the purchase resulted in all the estate's cash being transferred to the secured creditor, the court concluded the cash the secured lender gave for the escrow and settlement fund were not consideration for the purchased assets, so the cash was not proceeds of the sale or property of the estate.[30] The analysis makes no sense, as noted above. If the lender had left the cash in the estate, rather than purchasing the cash and paying it into the escrow and settlement fund, even the court would have found the cash to be property of the estate. Form should not prevail over substance.[31] So viewed, the payment came from proceeds of property of the estate, it did not

*This "standard," such as it is, is vague for now, but it would not include the kinds of issues expressly discussed in Professor Baird's Essay or in this Response.

26 Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978, 981 (2017).

27 *Id.*

28 *In re* ICL Holding Co., Inc. 802 F.3d 547, 549 (3d Cir. 2015).

29 *Id.* at 551.

30 *Id.* at 556.

31 Pepper v. Litton, 308 U.S. 295, 305 (1939) ("substance will not give way to form . . . .").

enhance the estate's value, it did not resolve interclass entitlement disputes, and it was not paid pro rata to all holders of administrative claims, who did not accept. It should have been disallowed.

The written rules also might help address a common hypothetical sale evaluation, conveniently provided in a sidebar by Professor Baird:

> One group of creditors consists of prepetition suppliers owed $20. The balance of creditors are institutional lenders owed $80. The debtor wants to sell its assets as a going concern. One buyer offers to pay the estate $50 for the assets of the firm. This buyer has no relationship with the suppliers and is indifferent as to how the $50 is distributed. Under bankruptcy's pro-rata sharing rule, each creditor receives half of what it is owed. The suppliers will receive $10 and the other creditors $40. A second buyer appears and bids $40 for the firm. The suppliers are small and dispersed and are not actively involved in the bankruptcy case, but this buyer is in the same industry as the debtor, and it has an ongoing relationship with virtually all of these prepetition suppliers. Because it does not want to jeopardize its relationship with them, this second buyer will top off the prepetition suppliers and pay them an additional $12 later on if it acquires the firm. For this reason, if the second buyer's bid is accepted, the suppliers and the other creditors as a group will ultimately receive $52 [although only $40 is paid out from the bankruptcy estate.][32]

Measured against the "written rules," the court should approve the $50 bid. Although the hypothetical involves a bid rather than a payment, it implicates a payment, the $12 post-closing payment from the $40 bidder to the suppliers. The payment does not enhance the estate's value, it does not resolve an interclass dispute, is not distributed pro rata to all members of the class, and does not settle a bona fide legal or factual dispute.[33] Another reason the court should not approve the $40 plus $12 bid is that we does not want players going around the court process to make payments. That undercuts the court's policing role.

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[32] Douglas Baird, et. al., *The Bankruptcy Partition*, 166 U. PENN. L. REV. 1675, 1682 (2018).

[33] A somewhat simplified hypothetical, to be sure. Adding an undersecured creditor with a pervasive lien complicates matters, as general unsecured creditors would likely receive nothing under either offer. So payment of the preferred creditors involves violation of the priority rules, and if the secured creditor does not consent, then the court should approve the $50 bid. Adding an undersecured creditor with less than a pervasive lien further complicates analysis, especially because of the practical difficulty of allocating purchase price to encumbered and unencumbered assets, but the rules can still be applied.

Professor Baird makes a useful point about the bankruptcy judge's policing role and the importance of the boundaries of the field in which the players joust. However, those boundaries are available in writing to all who would search and, as I attempt to show, can probably be summarized fairly accurately. That said, we appoint judges to have that quality we call judgment, which provides the elastic in the rules so that they are applied sensibly and constructively to achieve fair and equitable results in reorganization cases that are consistent with Congress's design. Whether we write down the rules or leave them unwritten, we should rely on those judges to exercise judgment.